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In the Supreme Court of the United States

OCTOBER TERM, 1937

No. 189

BENJAMIN B. FOSTER AND ROBERT R. TODD, EXECUTORS OF THE ESTATE OF ANNA FOSTER FORD, DECEASED, PETITIONERS

v.

THE UNITED STATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The original opinion of the court below (R. 7–15) is reported in 17 F. Supp. 191. Its supplemental opinion on petitioners' motion for a new trial (R. 15–19) is reported in 18 F. Supp. 790.

JURISDICTION

The judgment of the court below was entered December 7, 1936. (R. 15.) The order overruling petitioners' motion for a new trial was entered

April 5, 1937. (R. 19.) The petition for a writ of certiorari was filed July 2, 1937. (R. 19.) The jurisdiction of this Court is invoked under Section 3 (b) of the Act of February 13, 1925.

QUESTION PRESENTED

Whether a dividend in 1930 was paid from earnings accumulated between 1913 and 1929. This depends upon whether, under a proper construction of Section 115 (c) of the Revenue Act of 1928, a distribution in partial liquidation in 1929 can be considered as having exhausted such earnings.

STATUTE AND REGULATIONS INVOLVED

The pertinent portions of the applicable statute and Treasury Regulations are set forth in the Appendix, *infra*, pp. 11–13.

STATEMENT

This is a suit to recover an alleged overpayment of taxes for the year 1930. (R. 1–7.)

The special findings of fact of the Court of Claims (R. 7–11) may be summarized as follows:

Petitioners' decedent, originally the plaintiff in this case, died March 30, 1936, and petitioners, the executors of her estate, were substituted as plaintiffs. (R. 7.) For the calendar year 1930, the decedent filed her income tax return showing a net income of $29,697.29, and a tax thereon of $850.28, which was paid at the time the return was filed. (R. 7–8.)

On February 11, 1930, decedent was the owner of 155 shares, par value $100 per share, of the total capital stock of 1,500 shares of the Foster Lumber Company, a Missouri corporation. She acquired this stock prior to March 1, 1913, at a cost less than the value as of that date which it was agreed was at least $2,000 per share. On February 11, 1930, the corporation duly declared and paid a cash dividend of 150%, and decedent received as her share thereof the amount of $23,250, which was included in her income tax return for that year as income, and a tax paid thereon. (R. 8.)

On July 18, 1932, decedent filed a claim for refund in the amount of $712.01 for the year 1930, on the ground that of the cash dividend received by her in February 1930, the amount of $14,754.22 was paid out of surplus accumulated or appreciation of land and timber arising before March 1, 1913, and was to that extent and for that reason exempt from tax. This claim for refund was rejected on September 21, 1933. (R. 8.)

On March 1, 1913, the earnings or profits accumulated and the increase in value of property owned by the company were in excess of $3,725,000. (R. 8.)

Finding 6 made by the Court of Claims, at pages 8 and 9 of the Record, sets forth a tabulation of the amount of earnings and the dividends distributed during the period from February 28, 1913, to December 31, 1930. It is not believed this tabulation

need be repeated here, as the relevant amounts therein are found as separate facts by the Court of Claims as hereinafter stated. (R. 8–10.)

The dividends distributed by the corporation from 1916 to February 12, 1929, were distributed from earnings and profits accumulated subsequent to February 28, 1913. (R. 10.)

The stock of the corporation was owned by members of the Foster family, and for family reasons it was determined, in July 1929, to reduce the total capital stock from $200,000 to $150,000 by the acquisition from the stockholders and the cancellation by the company of 500 shares of the total outstanding of 2,000 shares. (R. 10.) On October 10, 1929, the corporation pursuant to a resolution, distributed to its stockholders $1,025,000 in cash for 500 shares of its capital stock, and this stock was retired and cancelled on that date. On the books of the corporation, $975,000 of the amount distributed was charged to surplus, and $50,000 to the capital stock account. This distribution was on the basis of $2,050 per share, and subsequently it was agreed between the stockholders and the Commissioner of Internal Revenue for the United States that the value of the stock on March 1, 1913, was $2,050 per share, and therefore no income taxable to the stockholders arose out of the retirement of the stock in 1929. (R. 10–11.)

The earnings and profits of the corporation on October 10, 1929, prior to the distribution of

$1,025,000 on that date, and which had been accumulated since February 28, 1913, were $330,578.98. (R. 11.) The accumulated earnings and profits of the corporation for the period from October 10, 1929, to February 11, 1930, and prior to the cash dividend of $225,000 on the latter date, were $82,758.17. (R. 11.)

On the foregoing special findings of fact, the Court of Claims decided as a conclusion of law that petitioners were not entitled to recover, and dismissed the petition. In a supplemental opinion on petitioners' motion for a new trial, the Court of Claims adhered to its prior decision and overruled the motion.

ARGUMENT

Section 115 of the Revenue Act of 1928 (Appendix, *infra*, pp. 11–12) contains the provisions relating to distributions by corporations here involved. In subdivsion (a) thereof, it is provided that the term "dividend" as used therein means any distribution made by a corporation to its shareholders out of its earnings or profits accumulated after February 28, 1913. Under subdivision (b), the presumption is set up that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, and exempts from tax any earnings or profits accumulated prior to March 1, 1913, if distributed after the earnings and profits accumu-

lated since February 28, 1913, have been distributed. Subdivision (c) contains an exception to the provisions of subdivisions (a) and (b), and therein it is provided, in respect of amounts distributed in partial liquidation, that the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of subsecton (b) for the purpose of determining the taxability of subsequent distributions by the corporation.

Subdivision (h) defines the term "amounts distributed in partial liquidation" as meaning a distribution by a corporation in complete cancellation or redemption of a part of its stock. It is not disputed here that the distribution by the Foster Lumber Company on October 10, 1929, was in partial liquidation, resulting in complete cancellation or redemption of a part of its stock.

The provisions of Section 115 (c) of the Revenue Act of 1928 first appeared in the Act of 1924, c. 234, 43 Stat. 253, as Section 201 (c). This was new legislation not contained in the 1921 Act, and both the Senate and the House Committees, in reporting the bill, which became the Act of 1924, made the following statement (S. Rep. No. 398, 68th Cong., 1st Sess., p. 12; H. Rep. No. 179, 68th Cong., 1st Sess., pp. 11–12):

> The theory of liquidating dividends is extended to distributions in partial liquidation.

> If a corporation retires a portion of its capital stock, the transaction is treated, from the point of view of the stockholder, as a sale of his stock. If the corporation distributes an amount in partial retirement of its capital stock, the amount thereof is to be considered as a return of capital; and taxable only if, as, and to the extent that, it exceeds the basis of the stock.

From the foregoing it is clear that Section 115 (c) must be considered "from the point of view of the stockholder" and not in relation to the accounting methods or practices of the corporation. For the year 1929, petitioners' decedent contended that the amount received in the distribution made on October 10, 1929, was a return of March 1, 1913, value or capital to her, and therefore was not taxable as income, and as it was agreed that the amount received was equal to the basis of the stock, it was conceded that it should not be taxed. (R. 10–11). Thus, in the instant case, we have a situation in which petitioners' decedent, in 1929, contended that the entire amount received in the 1929 distribution was properly chargeable to capital account. Considering the matter from the point of view of the stockholder, as Congress has indicated it must be, it is plain that this contention made by the decedent in 1929 was correct. The statute is directed to the determination of the income of the stockholder, and the meaning of the phrase "properly chargeable to capital ac-

count" must be sought from the use of that term in its application to the stockholder. To the stockholder the receipt of the March 1, 1913, value of the stock was the realization of capital and was properly chargeable to capital account. On this basis, Section 115 (c) sets forth the rule that amounts distributed in partial liquidation, to the extent that they are deemed to be a return of capital, shall not be considered a distribution within the meaning of subsection (b) for the purpose of determining the taxability of subsequent distributions. In other words, such a distribution in partial liquidation is not to be considered a distribution out of earnings or profits, either prior or subsequent to March 1, 1913, and, in fact, from the point of view of the stockholder is not a distribution of earnings or profits in any sense, but is merely a return of capital which is not to be, and in the instant case has not been, taxed. (R. 10–11).

The foregoing is the construction of Section 115 (c) and the exception therein contained to the provisions of subsection (b) adopted by the Court of Claims, and it is clearly correct when the purpose of the section as revealed in the reports of the committees of Congress is kept in mind. The burden of petitioners' argument is simply this: Because of the fact that the corporation, under common accounting practice, separated the distribution made in October 1929, by charging only

$50,000 thereof to capital and the balance to surplus, petitioners contend that the taxation of the cash dividend subsequently paid in 1930 constitutes a tax upon capital rather than upon income, on the ground that the distribution in October, 1929, more than exhausted the earnings and profits which had accumulated subsequent to March 1, 1913, and was made in part out of earnings accumulated prior to February 28, 1913, which were exempt from tax.

Under the provisions of Section 115 (c) (Appendix, *infra* pp. 11–12) the distribution in partial liquidation in October, 1929, was not a distribution out of earnings or profits; it was a return to the stockholders of the March 1, 1913, value of their stock or, in other words, of their capital. As stated above, this was the position taken by the decedent in respect of the year 1929, and decedent's representatives, petitioners here, should not now be heard to argue for a different position. Cf. *R. H. Stearns Co.* v. *United States,* 291 U. S. 54; *Crane* v. *Commissioner,* 68 F. (2d) 640 (C. C. A. 1st).

In the supplemental opinion rendered by the court below on motion for a new trial (R. 15–19) the principal authorities relied upon by petitioners are fully discussed and distinguished. None of these decisions relied upon by petitioners is authority for the proposition that the exception set up in Section 115 (c) (Appendix, *infra* pp. 11–12) should be disregarded under the facts in the instant case, or for the treatment of the distribution in partial

liquidation as made out of earnings or profits. As stated by the court below (R. 19), the memorandum opinion of the United States Board of Tax Appeals in the case of *Craig, Executor* v. *Commissioner,* decided March 15, 1937, did not contain the reasoning upon which the opinion was based, and insofar as that decision of the Board is contrary to the views expressed by the Court of Claims, we submit that it is incorrect and should not be followed. The Government has not acquiesced in the decision of the Board of Tax Appeals and an appeal therefrom to the Circuit Court of Appeals has been authorized and will be taken.

CONCLUSION

This case presents only an isolated question arising under special circumstances and is of no general public interest or importance. No actual conflict of decisions has been shown, and the result reached by the court below is correct. We respectfully submit that the petition should be denied.

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AUGUST 1937.

APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791, 822:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of dividend.*—The term "dividend" when used in this title (except in section 203 (a) (4) and section 208 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

(b) *Source of distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax; after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the basis of the stock provided in section 113.

(c) *Distributions in liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112.

In the case of amounts distributed in partial liquidation (other than a distribution within the provisions of section 112 (h) of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of subsection (b) of this section for the purpose of determining the taxability of subsequent distributions by the corporation.

* * * * *

(h) *Definition of partial liquidation.*—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

Treasury Regulations 74:

ART. 622. *Source of distribution.*—For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits.

ART. 623. *Distributions out of earnings or profits accumulated, or increase in value of property accrued, prior to March 1, 1913.*—Any distribution by a corporation out of earnings or profits accumulated prior to March 1, 1913, or out of increase in value of property accrued prior to March 1, 1913 (whether or not realized by sale or other disposition, and, if realized, whether prior to or on or after March 1, 1913), is not a dividend within the meaning of Title I. A corporation can not distribute earnings or

profits accumulated or increase in value of property accrued prior to March 1, 1913, exempt from tax, unless and until all earnings or profits accumulated since February 28, 1913, have been distributed. Whenever one corporation receives from another corporation distributions out of earnings or profits accumulated by such other corporation prior to March 1, 1913, or out of increase in value of its property accrued prior to March 1, 1913, and the "receiving" corporation, after having first distributed all of its earnings and profits accumulated since February 28, 1913, distributes to its shareholders the amount so received by it from such other corporation, the distribution by the "receiving" corporation to its shareholders is not a dividend within the meaning of Title I and is exempt from tax.

In determining whether a dividend is out of earnings or profits accumulated since February 28, 1913, or prior to March 1, 1913, due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive.

* * * * *

U. S. GOVERNMENT PRINTING OFFICE: 1937